



Operating Budget Fiscal Year 2005

William Donald Schaefer
Comptroller

**Response to Issues and Recommended Actions
of the Department of Legislative Services**

Comptroller of Maryland

Response to Issues and Recommended Actions

Issues:

1. Cooperative Agreement with the Internal Revenue Service

The Comptroller has replaced its outdated electronic tax filing system by contracting with the Internal Revenue Service to use their Fed-State filing system. We began working on this project in 2002 and implemented the Fed-State system in January 2004 for the processing of the 2003 Maryland personal income tax returns. We experienced some minor difficulties at the beginning with file transfer speeds and other technical matters, but those issues were corrected timely. The transition was virtually transparent to tax preparers and taxpayers using commercial software products. We do not anticipate any problems during this tax-filing season and intend to continue with the Fed-State filing system for many years.

2. Branch Closings

In the past, the Comptroller's branch offices would prepare Maryland tax returns for individuals who brought in their completed federal returns. Over the last few years the IRS has greatly reduced its tax preparation service, thus reducing the number of taxpayers that come to our branch offices requesting tax preparation services. This was a leading cause to the reduction in our customer base. There were also other factors impacting the workloads of our branch offices. The implementation of electronic filing, the use of commercial software products and the expansion of the Comptroller's website to allow internet filing of personal tax returns all added to the decline of our branch office customer base.

Beginning with tax year 2000, 123/503 returns (short forms) could be filed electronically through the Comptroller's website. This was a pilot project using the short forms and 19,247 returns were filed. This was expanded the next year to include not only the short forms but form 502 and 42,788 returns were filed. In 2003, 61,881 returns were filed electronically through our website.

In 2003, we provided for individuals to file an amended Maryland income tax return if they filed their original personal income tax return electronically. Over 1,100 amended returns were filed electronically. In 2004, if a taxpayer filed their original return electronically, they may file an amended Maryland income tax return for tax years 2002 and 2003.

Beginning in 2004, we will accept a nonresident return electronically through the Comptroller's website. We received 41,000 taxable paper nonresident returns in 2003.

In February 2003, we established our bFile system whereby businesses could file and pay their employer withholding taxes through the Comptroller's website using the direct debit method. We have received 20,910 transactions for \$173.5 million. In August 2003, we expanded our

bFile system whereby businesses could file and pay their Sales and Use Tax. To date, we have received 7,999 transactions for \$58.6 million.

In March 2004, we will begin accepting transactions for personal estimated taxes in which individuals may file and pay their quarterly estimated taxes through the Comptroller's website using the direct debit method.

We have advised the Internal Revenue Service we are ready to participate in the joint filing of corporate income tax returns and this is scheduled to begin in 2005 with a limited number of states.

As the use of these internet based services expand, we believe that the utilization of our branch offices will decline. It is our intent to maintain a presence in the seven regions outlined in the budget analysis, however, the number of branch offices per region, as well as the locations of these offices may change based on the needs of our customers.

3. Results of Tax Compliance Legislation Adopted in the 2003 Session

House Bill 935, Chapter 203 Acts of 2003, provided for a number of revenue-producing initiatives, with a variety of effective dates ranging from July 1, 2003 to January 1, 2004. On January 26, 2004, at the request of the budget analyst, we provided information on five of these initiatives, including our estimate of the revenue that could be expected for each of the five by June 30, 2004. The analyst did not include that information in his presentation and we are now including it for the benefit of the Committee.

Action	Original Estimate	Comptroller's Estimate
Withhold from the proceeds of nonresident real estate sales	\$10,000,000	>\$10,000,000
Expand license clearance to several state agencies	\$10,000,000	\$10,000,000
Streamline the bank attachment process	\$10,000,000	\$7,000,000

This provision became effective October 1, 2003. The Comptroller's efforts have been impacted by the fact that the financial institutions have not completed their programming for the automated data matches permitted under this legislation four times a year. The Compliance Division continues to work with the various institutions and the Bankers' Association to begin this process. To the extent that we can perform data matches before the end of the fiscal year, the estimated revenue impact may increase. The financial institutions have identified one

problem area in the legislation enacted in 2003 and the Bankers' Association, together with the Comptroller's Office, has drafted legislation for introduction in this Session that would alleviate the problem.

Permit direct salary attachment	\$1,000,000	\$500,000
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Payments from salary attachments are not lump sum resolutions of a taxpayer's liability, but, instead, come in weekly, bi-weekly, or monthly. As the number of payments being received through these attachments grows, the revenue will increase each month. We expect that the revenue received in FY05 from this program will exceed the estimate.

Withholding from non-resident contractors	\$3,000,000	\$1,500,000
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This provision impacted contracts entered into on or after July 1, 2003, so we expected some lag in receiving revenues. In addition, because this is an entirely new program, we have been conducting an educational program in an attempt to overcome the resistance of the contractor community. By the end of FY05, we expect the revenues to be on track.

The Department of Legislative Services included a 10% (\$4.8 million) reduction to the revenue estimates in the Fiscal Note to HB 935, to account for any overlap associated with the compliance activities. The concern was that all of the new compliance measures were focused on the same taxpayer base, and any one may satisfy the tax liability. Including this overlap provision, we believe that revenues from these activities are on target with the estimates for FY 2004.

4. Delaware Holding Companies to Pay Maryland Tax

We have been asked to comment on the results of the settlement offer to the Delaware holding company cases that have been assessed by the agency. Below is an updated chart as of January 30, 2004.

Status	Holding Companies	Total Tax, Interest through 1/31/2004 and 2% Penalty Assessed
Accepted	11	\$3,934,369
Paid without acceptance	1	\$58,581
Paid under protest	1	\$1,317,505
Negotiating other issues	7	\$5,757,336
Additional time granted	13	\$18,661,775
No response	10	\$1,818,309
Rejected offer	27	\$47,100,829
TOTAL	70	\$78,648,704

Crown Cork & Seal SYL, Inc.	\$2,119,298 \$949,088
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Additional gap year payments received to date:	\$1,824,768
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We have been asked to comment on the short and long-term revenue and operational effects anticipated as a result of this ruling. We are handling those cases that did not respond to our offer or rejected it outright, issuing administrative decisions if the cases are in the Compliance Division's Hearings and Appeals Section or asking the Maryland Tax Court to schedule hearings if the case is pending there. We expect to be collecting on these cases for years. We have many cases in audit this fiscal year, with many more planned next fiscal year. We have hired additional auditors to assist in this effort and have asked for additional positions in the FY05 request to add to the corporate audit program. The overall revenue effects will be impacted by actions the General Assembly takes this Session to eliminate the tax advantage of the parent company in deducting these payments to the holding company or to enact an amnesty program for these taxpayers.

We have also been asked to comment on the prospects of some of the firms who have rejected the settlement proposal winning an appeal of this ruling. Some of these holding companies are not identical to the companies like Crown and SYL. Some, for example, do financing rather than holding intellectual properties. Those companies are contending they are not covered by the rulings in Crown and SYL. We do not agree, and are prepared to litigate this issue.

5. Audits

Revenue Administration

The auditor found that methods to detect non-filers of income tax returns to be inadequate.

Specifically, the auditor looked at the automated W2 file with information received from employers for tax year 2001 and determined that there were taxpayers on that file who had not filed a 2001 return. As of January 2004 the number of taxpayers on that file with taxable income who have not filed a return has been reduced from 84,000 to 41,000. The Compliance Division has begun a program to match the W2 file for both 2001 and 2002 against the file of taxpayers who have filed Maryland returns for those years. The Division has agreed to identify those taxpayers who are delinquent for both years and set a priority to work those cases during the current calendar year. The Division will develop a program to detect and work the remaining non-filers for tax year 2001 after the cases with multiple delinquencies are completed. Thereafter, each year the Division will work these W2 non-filer cases in this priority.

Inadequate procedures allowed the processing of multiple income tax returns filed under the same social security number.

Letters were mailed to the 89 individuals identified asking them to provide us with proof that the social security number used was theirs. This had to be in the form of documentation from the Internal Revenue Service where that social security number and their name appeared.

If no response was received, their name and information was forwarded to the Compliance Division for follow up action and possible referral to the Criminal Investigation Division of the Attorney General's Office.

In processing tax year 2003 returns, if a social security number appears over a specified number of times (agreed upon with the Legislative Auditor), the return will stop being processed (suspend), all credits on the return will be denied to prevent a refund from being mailed, and a letter will be mailed asking them for documentation to prove the social security number used is in fact their social security number. If proof is received, the credits will be approved and the return processed. If no response is received the information will be forwarded to the Compliance Division for follow up action.

The auditor found that specific procedures were not established to ensure that lottery agents filed tax returns, nor is there a method to track winners who failed to report their winnings. The Compliance Division has performed a match of lottery agents against the business tax liability file. Any agents that were not in compliance were sent a notice by the Division advising them that they were subject to having their lottery license revoked for non-payment of taxes. The Division referred 19 cases to the State Lottery Agency for non-compliance. In addition, as the State Lottery Agency receives applications for new licenses, the Compliance Division reviews the taxpayer's status to ensure compliance before a license is granted. The Revenue Administration Division has obtained the required W-2G statements from the State Lottery Agency for 2001 and 2002 and will follow up on an annual basis to ensure compliance. The Compliance Division evaluated the 14 individuals with significant lottery earnings noted by the auditor for appropriate action, auditing 9 of the taxpayers and referring the other 5 to the Attorney General for criminal prosecution.

Interest and penalties were not always assessed for delinquent taxes as provided by law. The processing systems were updated in 2003 so that returns processed beginning January 2004 would be assessed the appropriate interest and penalty.

During calendar years 2000 and 2001, we processed 45,131 fiscal year corporation returns, of which 244 appeared to be delinquent and found not to have been charged interest and penalty. The most common reason a fiscal filer appears not to have filed timely is that there was an acquisition/consolidation. In that case they are entitled to the filing due date of the parent corporation and penalty and interest is not appropriate.

We have added a "check box" on the 2003 corporation income tax return where it is marked if this tax year's beginning and ending dates is different from last year's due to an acquisition/consolidation. These returns will be selected for review and follow up with documentation retained for the Legislative Auditor.

Central Payroll Bureau

Lack of proper internal controls over the processing of certain disbursement transactions.

The Bureau has taken immediate steps through the FMIS security features to establish the necessary, independent, on-line approval authority for all critical disbursement transactions.

Access to critical automated payroll processing functions were improperly granted to numerous CPB employees.

The Bureau has implemented changes to limit the access to the on-line function that was identified in the audit as well as other on-line, update functions to further limit access to CPB employees where feasible.

General Accounting

Adequate controls to ensure that all collections are deposited have not been established.

Proper controls have been established to ensure that the manager for Administrative Services processes collections and the Assistant Director will perform the independent deposit verification.

The division improperly retained \$385,000 in surplus general funds since fiscal year 2001.

The \$385,000 has been transferred to the State's general fund revenue as recommended.

Information Technology Division

There were insufficient controls over critical systems files.

In accordance with the auditors recommendation, all access to additional critical operating system files beyond what we monitored in the past, are now being logged and added to the existing manager approval procedure

Recommended Actions:

1. Add Budget Bill language requiring Comptroller to develop procedures for matching wage earnings and withholding data submitted by employers.

The Comptroller agrees with the proposed budget bill language and will establish the necessary procedures for the matching of wage earnings and withholding data.

2. Add Budget Bill language reducing reimbursable funds by \$100,000.

The Comptroller concurs with this recommendation

3. Reduce travel expenses by \$30,000

Extensive out-of-state travel relating to Delaware holding companies was halted in FY 2003, awaiting the decision from the Maryland Court of Appeals. With the Court ruling in favor of the Comptroller in June 2003, we began an aggressive audit program to identify other companies utilizing Delaware holding companies. Additional funds were set aside in FY 2004 to hire additional auditors and fund additional audit travel. We included an additional \$50,000 in our FY 2005 budget request to continue these audit efforts to bring millions of dollars in unpaid corporate income tax into the State. The analyst's recommendation to reduce travel funds can only undermine our audit efforts and may result in the loss of millions of dollars in revenue. ***We therefore encourage the committee to reject the analyst's recommended reduction.***

4. Delete 3 new Revenue Examiner positions and 3 new Field Auditor positions.

The analyst is basing this recommendation on his review of a vacancy report which shows the Comptroller having 14 Revenue Examiner and 3 Revenue Auditor vacancies. The analyst believes that with this number of vacant positions, there is no need for all 17 new positions. The fact of the matter is that the 3 Revenue Field Auditor positions included on the analyst's vacancy reports had been vacant for less than 2 weeks. The other 14 Revenue Examiner vacancies are spread throughout our other divisions. All of our divisions utilize Revenue Examiner positions to review tax returns and deposit checks received from taxpayers. However, only the Compliance Division utilizes Revenue Examiner and Revenue Field Auditor positions to audit and collect unpaid taxes. The Compliance Division was granted a blanket hiring freeze exemption by the Department of Budget and Management and has been filling all revenue producing jobs the minute they become vacant.

Cost containment reductions have left us with a \$3 million dollar shortfall in salaries for FY 2004. This shortfall in salaries is forcing our agency to hold nearly 64 positions vacant during FY 2004. We are filling our revenue producing jobs first and keeping all other vacancies unfilled due to our shortage of funds for salaries. If we had sufficient funding we would seek to fill all of our positions, especially the revenue producing jobs.

We do not disagree with the analyst's point, when you have vacancies, why ask for new positions. The fact is that we could agree to the reduction of the 6 positions as long as we have the funds to fill 6 of our vacant positions. We therefore offer a compromise. We will concur with the analyst's recommendation to delete 6 of the requested new positions with no reduction in funds. This will allow the Compliance Division to collect the \$3.26 million that is included in the Governor's FY 2005 budget.